The Financial Reform Plan: What It Means for Insurance Companies

*By Laura Kotelman**

On June 17, 2009, the U.S. Treasury Department released the Obama Administration's framework for financial regulatory reform. As part of the larger effort to strengthen the regulation of the financial services market, the Financial Reform Plan proposes certain reforms applicable to the insurance industry, including establishment of an Office of National Insurance (the "ONI") within the Treasury Department, modernization of insurance regulation in accordance with six fundamental principles, special treatment of large systemic insurance conglomerates (known as "Tier 1 FHCs"), and the creation of a Consumer Financial Protection Agency (the "CFPA").

I. Office of National Insurance

As proposed, the ONI would monitor all aspects of the insurance industry, primarily by gathering information and identifying the emergence of potential market problems or gaps in existing regulation that could contribute to a financial crisis. The proposal does not provide the ONI with any expressly enumerated enforcement powers; however, it is contemplated that the ONI will be empowered to work with other nations to better represent U.S. interests and increase international cooperation on insurance regulation. It will have the authority to enter into international agreements; carry out the federal government's existing responsibilities under the Terrorism Risk Insurance Act; recommend to the Federal Reserve Board any insurance conglomerates that should be regulated as Tier 1 FHCs (described in more detail below); and consult with the Treasury Department in connection with the orderly resolution of a failing Tier 1 FHC with insurance subsidiaries. Other than the ONI's role in negotiating international agreements, it is not clear from the Financial Reform Plan how the administration intends to implement these principles of reform, whether through federal statute, which could include an optional federal charter for insurance companies, uniform collective action at the state level, or some other implementation procedure.

The Financial Reform Plan enumerates six principles that the Treasury Department will support for modernizing the regulation of insurance:

- Effective systemic risk regulation with respect to insurance, which could be addressed in large measure by the adoption of the proposed Tier 1 FHC regulations;
- Strong capital standards and an appropriate match between capital allocation and liabilities, including risk management related to liquidity and duration risk;
- Meaningful and consistent consumer protection for insurance products and practices to address any gaps that exist under the current regulatory system;
- Increased national uniformity through an optional federal charter or effective action by the states. The Treasury Department described the current insurance regulatory regime as "highly fragmented, inconsistent and inefficient" with marked variances in consumer protections among the states;
- Regulation of insurance companies and affiliates on a consolidated basis, including non-insurance affiliates. The Treasury Department indicated that any new regulations should address the gaps in current insurance holding company regulations; and
- Coordination among international regulatory authorities.

II. Regulation of Tier 1 FHCs

The ONI would be responsible for recommending to the Federal Reserve Board any insurance conglomerates that the ONI believes should be regulated by the Federal Reserve Board as a financial institution whose failure could pose a systemic risk to the financial system (known as "Tier 1 FHCs"), regardless of whether the insurance conglomerate owned a bank or was regulated as a bank holding company. In its analysis, the ONI would consider, among other factors: the impact the insurance conglomerate's failure would have on the financial system and the economy; the insurance conglomerate's combination of size, leverage, and degree of reliance on short-term funding; and the insurance conglomerate's importance as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system.

The Financial Services Oversight Council that would be created to advise the Federal Reserve Board provides for no state role in this agency. The regulators who would constitute this panel would include the Secretary of the Treasury, who would serve as chairman; the Chairman of the Federal Reserve; the Director of the combined Office of the Comptroller of the Currency/Office of Thrift Supervision; the Director of the Consumer Financial Protection Agency; the Chairman of the Securities and Exchange Commission; the Chairman of the Commodities Future Trading Commission; the Chairman of the Federal Deposit Insurance Corporation; and the Director of the Federal Housing Finance Agency.

Being subject to the Tier 1 FHC regulations, in addition to other insurance regulations, could have a significant impact on large insurance companies. Once an institution is designated as a Tier 1 FHC, the Federal Reserve Board's supervisory authority would extend to the parent company and all subsidiaries, U.S. and foreign, including otherwise regulated subsidiaries. Although existing state insurance regulators would remain the primary regulator for an insurance company, the Federal Reserve Board would have the authority to provide its own level of oversight. Tier 1 FHCs could be subject to, among other provisions, increased capital and liquidity requirements and risk management standards (including application of severe stress scenarios). Tier 1 FHCs would be subject to the restrictions of the Bank Holding Company Act on nonfinancial activities,

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which could affect insurance companies that are affiliated with non-financial entities. Such insurance conglomerates may be required to divest themselves of any such non-financial subsidiaries within five years.

In addition, insurance conglomerates that are Tier 1 FHCs could be subject to a proposed special resolution regime providing for the quick and orderly resolution of failing Tier 1 FHCs. The resolution regime would apply to a particular Tier 1 FHC only when activated by the Treasury Department (in consultation with the ONI for insurance specific matters), and, unless activated, the resolution of a Tier 1 FHC would be governed by the U.S. Bankruptcy Code or applicable state insurance insolvency provisions, as the case may be. The Treasury Department would be given the power to decide resolution alternatives, which may include, among other features, appointing a conservator or receiver or stabilizing the failing Tier 1 FHC by providing loans, purchasing assets, guaranteeing the liabilities, or making equity investments with respect to the Tier 1 FHC. The Financial Reform Plan does not address the interplay of this special resolution regime with the traditional state-based insurance insolvency regime which would otherwise apply to insurance company subsidiaries.

III. Consumer Financial Protection Agency

The Financial Reform Plan proposes to create a new federal agency, the CFPA, with jurisdiction over credit, savings, payment, and other consumer financial products and services, other than investment products already regulated by the SEC or the CFTC. It is not clear from the Financial Reform Plan whether the CFPA is intended to have jurisdiction over insurance products. Although almost all examples noted in the Financial Reform Plan are banking products, the proposed general description of the jurisdiction of the CFPA would seemingly encompass many types of insurance products, as the CFPA is expressly intended to have jurisdiction over nonbanking entities. A clear goal of the CFPA is to consolidate federal consumer protection regulation, but the proposal explicitly permits concurrent state consumer protection regulation without federal preemption.

IV. The Future of Insurance Regulation

Under the proposal, the only role for federal authority in insurance would be the creation of an Office of National Insurance within the Treasury Department. However, a Treasury white paper detailing the reform plan states that the administration would support "increased national uniformity through either a federal charter or effective action by the states." Therefore, insurance companies could be subject to federal regulation through an optional federal charter regime, the regulation of insurance holding companies, the oversight of the CFPA, or international agreements arranged by the ONI.

Certain large insurance companies would be subject to unprecedented regulation by the Federal Reserve Board due to their status as Tier 1 FHCs. Insurance conglomerates that are failing Tier 1 FHCs may be subject to a special resolution process controlled by the Treasury Department. It is not clear how the special resolution process would affect the current state-based insurance insolvency system which would normally apply to insurance company subsidiaries. It is not clear whether the CFPA will have regulatory power over insurance products. The Financial Reform Plan does not clearly spell out if the roles of the federal government and state governments will be complementary or exclusive. The ONI within the Treasury would have the authority to recommend to the Fed any insurance companies that the ONI believes should be supervised as Tier 1 financial holding companies. However, the ONI does not appear to have enforcement powers, as compared to certain other federal regulatory agencies such as the SEC.

The National Association of Insurance Commissioners (NAIC), the organization of insurance regulators from the 50 states, the District of Columbia, and the five U.S. territories initially praised the proposal despite some federal regulatory encroachment. According to the NAIC, the proposal basically leaves the state insurance regulatory system intact, reserving the consumer protections and financial solvency oversight for the state-based insurance regulatory system. Nevertheless, state regulators will have to work with Congress and the administration to underscore the benefits of the current state-based insurance regulatory system. While, according to the NAIC, the plan addresses systemic risk and other regulatory gaps, consumer protection will remain priority one for state insurance officials. Who is better capable of adapting as insurance markets evolve will have to be answered by the companies they regulate.